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SUMMARY

¶1. (SBU) Jamaica's fragile economy has begun to feel the effects of the global financial meltdown, with the contagion effects already evident in the financial market. The local currency has depreciated by more than six percent since the beginning of October, due largely to margin calls from overseas creditors. The increased demand for hard currency could not have come at a worse time, as the country is going through its traditional dry season for foreign exchange earnings. Jamaica has also suffered from downgrades by three major rating agencies (S&P, Moody's and Fitch). To stem the slide in the currency, the central bank hiked interest rates and increased the supply of foreign currency. The Government of Jamaica (GOJ) offered an attractive US dollar indexed bond to the market. These measures could have negative implications for fiscal policy as debt costs increase. Although the pace of depreciation could slow in coming months, the pass through effect of depreciation could stymie the anticipated drop in consumer prices. End summary.

Financial Instability Emerges

¶2. (SBU) Jamaica has begun to suffer the effects of the global crisis with the country's currency market in turmoil. The Jamaican dollar (JMD), which depreciated 1.6 percent for the first nine months of the year, has slid by over six percent since the beginning of October, moving from JMD 72 to JMD 77.2 against the US dollar. The sharp depreciation has been underpinned by a confluence of demand and supply factors led by increased margin calls from overseas creditors. With the value of Jamaican global bonds declining on the back of the financial meltdown, overseas brokers who had provided margin loans to local firms to buy these instruments demanded payment of the outstanding amounts to shore up their liquidity position. Overseas suppliers faced with liquidity constraints also shut the credit window they traditionally provide to Jamaican importers, thus, requiring traders to secure foreign currency upfront in order to make purchases.

¶3. (SBU) Demand pressures are also being compounded by increasing JMD liquidity as local financial institutions convert maturing debt instruments into hard currency. The increased demand for hard currency could not have come at a worse time as it coincided with the slow period for inflows and the traditional demand spike for foreign currency to purchase Christmas supplies. (Note: Tourist arrivals tend to be slowest during the September quarter, commonly

referred to as the tamarind or dry season. End note.) Revenues from bauxite companies have also declined on the back of falling aluminum prices. The large amount of foreign exchange invested (and now lost) in the infamous collapsed alternative investment schemes (reftels) have further reduced the supply of available hard currency.

The Negative Ratings Trifecta

¶4. (SBU) The single greatest shock to the foreign exchange market came from the ratings released by Standard and Poor's (S&P) Ratings Services (reftels). On October 21, 2008, the agency revised its outlook on Jamaica to "negative" from "stable," although the credit rating was maintained. S&P is particularly concerned about the country's weak fiscal position, narrow economic structure and rising external liquidity risks. The S&P posits that external pressures could stymie already moribund economic growth, strain government access to credit, and weaken the country's external liquidity profile. These factors could further weaken the currency, with attendant negative implications for fiscal performance and the debt, given the GOJ's reliance on external borrowing. But worse yet, the S&P concluded that the negative outlook could lead to a downgrade if external pressures add to fiscal uncertainty, increase capital outflows or significantly impair external liquidity.

¶5. (SBU) Moody's Investors Service also placed Jamaica's ratings on review for downgrade. The agency stated that despite the GOJ's adequate policy response and continued strong commitment to servicing debt, the challenges imposed by the global financial crisis and economic slowdown are simply too severe for Jamaica to avoid an increase in credit risk. According to Moody's "the combination of a fiscal deterioration and lower real GDP growth would lead to a worsening of Jamaica's debt metrics".

¶6. (SBU) This was closely followed by an even more negative rating from Fitch, which downgraded Jamaica's actual credit ratings from 'B' to 'B+'. The agency cited shocks from the global financial turbulence; the expected US recession; deteriorating external imbalances; and, high public debt as the underlying factors for its decision. 'The recent depreciation pressures on the Jamaican dollar, as well as sales of international reserves, signal rising challenges facing the island due to the worsening international environment," said Shelley Shetty who met with emboffs during her recent visit to Kingston.

¶7. (SBU) These less than flattering ratings compounded an already tenuous situation, precipitating a further slippage in the JMD as local investors switched assets from local to foreign currency to hedge against any fallout from the report. Bank of Jamaica (Central bank) Governor Derick Latibeaudiere, speaking at his Quarterly Monetary Policy Review briefing, said that the ratings agencies analysis was disingenuous. He stated that the ratings were inconsistent and given the agencies' history of massive errors as being played out on Wall Street, their analysis if not their credibility was at best questionable. A realignment of the currency was anticipated given the 16.8 percent spike in inflation from January to September which in effect represented an almost 15 percent real appreciation in the currency. High inflation was rendering near negative returns on local instruments, encouraging savvy investors to switch to foreign assets to hedge against any further erosion in real returns. High commodities prices, led by oil imports, caused a USD 793 million deterioration in the current account balance to June 2008. As foreign investment inflows dry up and the credit market are severely tightened there would have been a shortfall in the supply of foreign inflows required to finance the current account, forcing the exchange rate to adjust accordingly.

Fiscal and Monetary Authorities Fight Back

¶8. (SBU) The increasing instability is not lost on the authorities, as the BOJ draws from its arsenal of monetary tools to temper the demand pressures. On October 15 the BOJ introduced a temporary U.S.

dollar loan facility for institutions affected by margin calls. In essence, the facility allowed securities firms facing the risk of losing credit facilities in respect of GOJ bonds to have these credit arrangements transferred to the BOJ along with the collateral formerly held by overseas creditors. Two days later the bank complemented this response by hiking interest rates on its open market instruments by up to 1.2 percent. The bank followed up by facilitating the flow of credit among financial institutions to moderate the pressures in the foreign exchange market, while assisting the continued functioning of the inter-bank credit market. At the same time, the bank sold over USD 400 million or 20 percent of its stock of Net International Reserves (NIR) to the currency market to shore up the supply of US dollars in the market.

¶9. (SBU) However, these policy responses were not sufficient to alleviate the demand pressures in the currency market. In fact, since the beginning of November, the rate of depreciation has accelerated due largely to a build up in Jamaica dollar liquidity stemming from maturing debt instruments. To remove this excess liquidity, the bank embarked on an even more aggressive monetary program, offering an attractive short-term instrument with interest payable at 20.5 percent (per annum rate). The BOJ also gave notice that when the new instrument matures on December 3, 2008, the cash reserve requirement would be increased by two percentage points to 11 percent. These monetary policies were accompanied by an 18-month GOJ USD indexed bond with a coupon of 11.5 percent. In addition to moral suasion, Minister of Finance and the Public Service Audley Shaw has also been calming fears in the market by announcing a pending agreement for the IDB to provide liquidity support to commercial banks. He also disclosed that the World Bank, the IDB and the Caribbean Development Bank have committed to providing the additional USD 250 million required to pay down a maturing Eurobond. In addition, the Managing Director of the International Monetary Fund (IMF) Dominique Strauss-Khann is to visit Jamaica in early December.

But At What Cost

¶10. (SBU) Although these measures should bring improvements in the short term situation, they could have serious consequences for both monetary and fiscal policy. While the latest monetary actions could halt the slide of the currency, it has eroded a significant portion of the BOJ's stock of NIR, reducing it to just over USD 1.7 billion from a peak of USD 2.5 billion in June. Effectively this steep decline has reduced the country's import cover to about 11 weeks or returning to levels last seen in 2003. The increased indicative

interest rates combined with declining liquidity have already induced a response from financial institutions, which have adjusted rates by up to three percentage points. This is bound to crowd out private credit and investment and by extension growth as investors find it more attractive to hold cash in relatively low risk government paper. Worse yet, the GOJ which is already reeling under high debt costs, could see its fiscal indicators deteriorate on the back of rising domestic interest rates. Even though the GOJ has met its fiscal targets for the first half of the year, rising debt cost will make it difficult for the GOJ to continue on a positive fiscal trajectory.

Measures Appearing to Work

¶11. (SBU) All is not lost as the strict monetary policies appear to be working, with over half of the liquidity from maturing instruments already mopped up. In addition, only USD 170 million of the USD 300 million has been accessed by financial institutions, suggesting that signs of confidence are emerging. The temporary window has also had the effect of tempering the price movement of GOJ bonds while at the same time easing the demand for foreign exchange by the institutions affected. Even though the NIR has fallen to just above USD 1.7 billion it is still above December 2007 levels. Most importantly, there is no apparent systemic risk to the financial sector, with most of Jamaica's prudential indicators still

above international standards. The capital adequacy ratio is currently at 16 percent, well above local and international benchmarks of 10 percent and 8 percent, respectively.

Comment

¶12. (SBU) While the monetary actions implemented by the BOJ appear to be working, it should still be noted that Jamaica is one of the few countries to have introduced such measures in response to the meltdown (other countries have opted for stimulus packages). The fear of high interest rates and slow economic growth could explain why the confidence required to stabilize the local system remains elusive. But waning confidence and uncertainty are not new to the Jamaican economy, as in 2003 a similar sequence of events unfolded, suggesting the country is locked in a vicious cycle of instability. Therefore, unless deliberate attempts are made to address the structural problems facing the economy, and in particular the twin deficits (fiscal and current account), it is almost safe to assume bouts of instability will reoccur. Prime Minister Bruce Golding and his Jamaica Labour Party (JLP))-led government are facing increasing pressure from a populace that question Golding's leadership. Golding has not been able to secure major victories on his campaign promises and appears reluctant to have a frank discussion with the public on the serious economic challenges facing the country.

¶13. (SBU) That said, some positives are emerging: even though the pass through effect of depreciation will feed inflation, the recent moderation in commodities prices in general and oil prices in particular, will more than offset this increase. Declining commodities prices combined with the depreciation should also correct the current account imbalance, even if remittances and tourism receipts wane. Tourism will likely benefit from the currency correction, as American visitors find Jamaica a more cost competitive destination. Add to this the fact that the GOJ's external debt servicing cost will moderate next year, and the outlook brightens slightly.
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